

Questions About the Financial Crisis

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"The problem [of loan defaults] will be significantly bigger next year [2008] because 2006 [mortgages] had lower...standards."

Henry Paulson, U.S. Treasury Secretary

"The best way to destroy the capitalist system is to debauch the currency. By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens."

John Maynard Keynes (1883-1946)

Questions from the Turkish Daily News, Istanbul, Turkey.

Question No 1- What triggered the US subprime crisis? can you compare it to past crises such as the 80s crisis?

Answer by Dr. Tremblay:

Four interrelated factors are responsible for creating the ongoing [subprime mortgage] financial crisis that is raging in the United States today.

First, monetary policy. After the technology dotcom bubble burst in 2001 and brought about the March to November 2001 recession, the Greenspan Fed aggressively lowered the Federal Funds rate from 6.5% to 1% in 2004, the lowest it had been since 1958. It is considered now that this was excessive, and that the Fed should not have lowered the Federal funds rate below 2%, and that it should have begun to raise it sometime in 2002. Indeed, from 2002 to 2004, the American central bank pursued a monetary policy that was too expansionary. Former Fed Chairman Alan Greenspan has argued to explain his policies that he was afraid of an onset of deflation, but few economists agree with him. Between 2002 and 2004, the Fed had no need to keep real short term interest rates so negative for so long, especially as the Bush administration was cutting tax rates and increasing military expenditures with its military invasion of Iraq.

Second, the housing boom. Abnormally low interest rates in the U.S., but also elsewhere because of the interconnections between money and capital markets, fed a housing boom world-wide which was unsustainable because partly based on price speculation. Indeed, mortgage rates in the U.S. remained low, even after the Fed started to raise the Federal funds rate from 1% in mid-2004 to 5.25% in June 2006. This was brought about by Americans borrowing huge amounts abroad. —In 2006, the U.S. current account deficit even reached 6% of GDP. China, Japan and oil-producing countries were the main buyers of U.S.

Treasury bills and bonds.

Third, new banking rules. With ever rising house prices, lending institutions relaxed their lending rules as the housing collateral behind the loans was gaining in value. Mortgage banks and other lenders began to accommodate subprime borrowers with dubious credit by extending mortgage loans to homebuyers who would not have qualified in other times. Nontraditional home loans were advanced to borrowers who had no documented incomes. Some loans were interest-only loans with down payments of 5% or less. Some were adjustable rate loans (ARMs), with low rates for one or two years to be reset later at much higher rates. In 2006, about 25 percent of American mortgages were subprime and close to 20 percent were adjustable rate loans.

Fourth, new financial instruments. With the demand for mortgage loans increasing, large banks resorted to some inventive financing of their own in order to economize their capital. They began repackaging loans and slicing them into some exotic new types of securities, and in so doing, shifted their lending risk to the buyers of such securities. Thus came into being a new class of securities—often rated AAA by credit rating agencies—that money market funds, insurance companies, pension funds and other investors could purchase.

These new “structured investment vehicles” (SIVs) came under various names such as “Collateralized Bond Obligations” (CBOs) or “Collateralized Debt Obligations” (CDOs). They had the characteristics of unfunded short-term asset-based commercial paper (ABCP). It is this ABCP market which is unraveling presently in the United States and elsewhere, and which is at the center of the current financial crisis. At its peak in the summer of 2007, the U.S. ABCP market was valued at some \$1.170 trillion. It has fallen now to some \$900 billion and is still contracting, as banks write down bad debts. [N.B.: This process of financial disintermediation may last many years.]

The savings-and-loans crisis of the early 1980’s was also a serious blow to the U.S. economy. Over 1,000 savings and loan financial institutions failed, and losses were estimated to have totaled around \$150 billion. As well, the crisis was a contributing cause to the 1990-1991 recession. This time around, the financial crisis is at the very least as bad, if not worse, because it involves the integrity of the entire American banking sector. The extent of the losses this time is not yet fully known, but everybody agrees that it will be very substantial.

[Another 1990 example is the near failure of the hedge fund Long-Term Capital Management (LTCM), in September 1998. The Federal Reserve (FED) had to intervene in panic and provide liquidity in order to prevent a forced liquidation of the large positions held by LTCM, which would have depressed bond prices and hike interest rates, at a time there was a financial crisis in Asia. —N.B.: Hedge funds are essentially speculative private entities that take risky financial positions in interest rate, currency and commodity derivatives, and in financial markets in general.]

Question No 2- How will the average American be affected?

Since home ownership is a large portion of the average American’s net worth, declining house prices and foreclosures on delinquent mortgage loans are bound to reduce private consumption spending in the coming months through a negative “wealth effect”. The loss of jobs and incomes in the construction and financial industries is also going to negatively

impact consumption spending. Above all, the average American may have to reduce his debt load. Together, mortgage debt and consumer debt account for some 125 percent of disposable income. These are historically high levels.

Question No 3- How do you assess Fed's policies after the outbreak? What is your opinion about the scepter of inflation?

Well, as I wrote on my blog of last September 21, I think the Bernanke Fed panicked when it announced a larger than expected half percentage point cut in both the federal funds rate and in the discount rate, and this after having slashed its discount rate by a half point, on August 17 (2007). The purpose was to facilitate distress borrowing by America's largest banks and to facilitate the bailout of their affiliates (known as conduits) and other operators, such as hedge-funds, caught in the sub-prime loans crisis. In so doing, the Bernanke Fed is, to a certain extent, following Walter Bagehot's advice for aggressive discounting in a situation of financial crisis. The only problem is that Bagehot's rule calls for the central bank to lend copiously in times of critical credit stringency ... but at a high rate of interest. By lending to troubled lenders at reduced preferential rates, the Fed has been acting as their "government" or their "insurer", i.e. subsidizing their risky loans operations and innovative finance, while taxing anybody else who holds American dollars. It is not only attempting to make the banks more "liquid", but also more "solvable" and less likely to fail.

In so doing, and especially with its policy of abandoning the dollar in foreign exchange markets, the Bernanke Fed is sowing the seeds of future inflation. All the new money that has been injected into the financial system will be difficult to retrieve and inflationary pressures should begin to show in a few years, after an expected economic slowdown. The more so that the 54-year average long inflation-disinflation-deflation Kondratieff cycle is about to run its course by 2010-11. A new inflation phase should begin thereafter.

Question No 4- When the US coughs, the world gets flu, they say. What will happen when the US gets a flu such as this? What are the prospects for emerging market such as Turkey, which rely on exports, plus have seen massive foreign capital inflows during the past 5 years?

The U.S. economy accounts for about one quarter of the world economy, so it is reasonable to expect that an American slowdown will impact other economies. As of now, Europe and Asia are still booming. However, the decline in the U.S. dollar and the concomitant appreciation of the euro and most other currencies, coupled with the rise of the price of oil, is bound to have a negative impact on these economies. In fact, it can take as much as two years for a currency over appreciation to impact the real economy.

The danger for Turkey is to be caught with an overvalued currency while pursuing an export-led growth strategy. Indeed, in the last few years the (new) Turkish lira has risen against the U.S. dollar and even against the euro. This has had beneficial effects in the fight against inflation, but this also could hurt future growth. The most recent example of such a predicament was Argentina, in the late 1990's, which was forced to abandon its peg to the U.S. dollar.

Question No 5- Do you perceive a difference of approach between the Anglo-Saxon economies and continental Europe economies, which have, for the most part, come out unscathed?

As you know, some European banks had to be bailed out after suffering huge losses coming from their asset-backed commercial paper operations. As a consequence, the Bank of England and the European Central Bank have injected huge sums of new money in their banking sectors. In the U.S., the Fed has a double mission, which is to contain inflation but also to accommodate economic growth. In Europe, the ECB's central mission is to contain inflation. This does not mean that there are not political pressures to abandon the fight against inflation in order to spur growth, as Mr. Sarkozy's campaign against Mr. Trichet's policies well illustrates. On the whole, however, it would seem that the rush toward irresponsible banking practices was less prevalent in Europe than in the United States, and that the negative impact should be less prevalent in Europe than in the USA.

Question No 6- What is the lesson to be learned from this crisis, and what kind of precautions should be taken?

Obviously, there was a lack of diligence and supervision on the part of central banks and of other regulatory agencies, especially in the United States. Former Fed Chairman (1951-1970) William McChesney Martin once said that "The job of the Federal Reserve is to take away the punch bowl just when the party starts getting interesting." —As the subprime financial crisis was getting up steam, the Greenspan Fed seemed to have been too close to the Bush administration and its political objectives and not enough aware of the danger that new financial rules were creating for the health of the financial system and of the economy as a whole. The Fed should have taken the monetary punch bowl away in 2003-04, but it did not. We still do not know the extent of the damage that has been done to the real economy. I hope it can be contained and will not spread.

Question No 7- Do you foresee a US recession?

Fed Chairman Ben Bernanke and U.S. Treasury Secretary Henry Paulson do not see a recession in the U.S. in 2008. As for myself, I think an economic slowdown is unavoidable in 2008. I do hope that the worst-case scenario will not materialize. However, I expect nevertheless a mild American recession in 2008, to be followed by a more severe one in 2010-2011 (at the trough of the 10 year cycle).

Question No 8- What will be the impact on a- The dollar?

Well, the U.S. dollar has been declining for many years and is hitting all-time lows against the euro. In 2000, the euro was worth less than 83 cents, but it is now close to \$1.50, a 45 percent depreciation for the dollar. I think the current phase of the dollar decline is close to have run its course. Barring some big geopolitical shock, the U.S. dollar could rebound in the months ahead. It is presently very much oversold.

Over the long run, we have entered a period where the demand for energy and resources is going to be strong relative to supplies. This should favor the currencies of resource-based economies, such as Canada, Australia and the emerging economies in general.

Question No 9- What will be the impact on oil prices?

Oil prices have been the mirror image of the decline of the U.S. dollar. At close to \$100 a barrel, the oil market is either close to a top, or is factoring in a Bush-Cheney bombing of Iran and a resulting serious disruption in oil shipping in the gulf of Hormuz. If there were to be a conflict between the United States and Iran, oil prices could go much higher, before

plummeting down due to a worldwide recession. If it turns out that there is no hot conflict with Iran and no disruptions in the supply of oil, the present high prices would logically ratchet down.

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